Insurance credit scoring: 21st century redlining and the end of insurance


By Birny Birnbaum

You've just been laid off from your job. Or your daughter has a major medical problem that your health insurance (if you have any) doesn't fully cover. Or you've just gotten a divorce. These three life events account for 87 percent of family bankruptcies, according to the Consumer Bankruptcy Project's report titled, "The Two Income Trap" published in 2001. To help you out in this stressful time, your insurance company will raise your homeowners and auto insurance rates because of insurance credit scoring.

The disagreements about insurance credit scoring really boil down to what "fair" means. For insurers, "fair" means that an insurer can produce some kind of data showing a statistical relationship between credit scores and insurance losses. For consumer groups, such a statistical relationship is a necessary, but not sufficient, definition of fair insurance practices. Fair rating factors must also not penalize consumers for rational behavior, for factors outside of their control and for arbitrary practices of insurers and lenders. Fair means that consumers who are the victims of some economic or medical catastrophe or natural disaster are not penalized because they were unlucky enough to lose their jobs, have a family member get sick, get divorced or become displaced by a hurricane or flood.

The list of reasons why insurance scoring is arbitrary and unfair is long. Here are just a few.

Insurance scoring undermines the loss prevention role of insurance because it deemphasizes rating factors under the consumer's control and encourages consumers to spend time and money on manipulating credit information.

Good credit, bad score

Because credit score depends on having the right kind of information in a credit report, someone can have a perfect credit history and still get a bad credit score. Contrary to insurer credit scoring myths, credit score has nothing to do with financial responsibility. Fair Isaac, the inventor of credit scoring models, estimates that 20 percent of the population is unscorable with traditional credit bureau reports because of "thin" files and this group of "unscorables" is disproportionately poor and minority.

Insurance scoring penalizes consumers for the business decisions and practices of lenders. Abuses by credit card companies and lenders place many consumers in financial distress. Consumers should not be penalized with higher auto and homeowners insurance rates because of abusive subprime mortgage lending or because a lender decides not to report information to a credit bureau.

Insurance scoring has a disproportionate impact on poor and minority consumers. A recent study by the Missouri Department of Insurance found that a consumer's race was the factor most predictive of insurance score. And despite relying on data hand-picked by insurers, the recent report by the Federal Trade Commission (FTC) found that insurance scoring was a proxy for race. If insurers are prohibited from using race as a risk classification, they should not be able to use a proxy for race.

FTC report biased and flawed

Insurers will tout the FTC report as affirmation of insurance scoring, but the report is so biased and methodologically flawed that one of the FTC commissioners voted against issuing the report and wrote a detailed criticism of the report. The report appears to have been written by the insurance industry. It dutifully repeats all the unsupported insurer claims about credit scoring. Insurers claim that credit scoring, by allowing "more accurate" pricing, promotes greater insurance availability and affordability. In fact, insurance scoring has led to lower loss ratios, excessive rates, higher numbers of uninsured motorist and more consumers in residual markets — refuting insurer claims that credit scoring is simply about more accurate pricing.

Insurance scoring undermines the key public policy goals of insurance. Insurance is essential for individual and community economic development for two reasons. First, insurance is an essential financial security tool that enables individuals and businesses to avoid financial ruin in the aftermath of a catastrophic event. Second, insurance is the primary mechanism for loss prevention and loss mitigation — preventing and minimizing loss of life and property from catastrophic events. Insurance accomplishes loss prevention by providing economic incentives for less risky behavior and economic disincentives for more risky behavior.

Insurance scoring undermines these policy goals because it makes insurance less affordable and available for those consumers who most need the economic protection of insurance — poor and minority consumers. Insurance scoring undermines the loss prevention role of insurance because it deemphasizes rating factors under the consumer's control and encourages consumers to spend time and money on manipulating credit information. Instead consumers should spend that time and money on activities that actually lead to lower losses — like weatherproofing homes or installing anti-theft devices in vehicles.

Insurance scoring represents 21st century redlining and the end of insurance as insurers develop ever more-detailed rating schemes based more on economic status — credit score, education, occupation, prior liability limits — than risk of loss and should be prohibited. IJ

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Report to the 79th Legislature

Use of Credit Information by Insurers in Texas

Texas Department of Insurance
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EXECUTIVE SUMMARY

Texas Insurance Code Article 21.49-2U, Section 15, requires the Texas Department of Insurance (Department) to present a report to the Governor, the Lieutenant Governor, the Speaker of the House of Representatives and the members of the 79th Legislature regarding the use of credit information by insurers in Texas. To prepare such a report, the Department obtained data from six leading insurer groups for approximately 2 million policies. Of these, approximately 1.2 million are for personal auto and 800,000 are for homeowners. The personal auto policies cover roughly 2.5 million vehicles. Six personal auto and three homeowners credit scoring models are represented in the data collection.

The Department obtained supplemental information from the Texas Department of Public Safety (DPS), including individual information on race. Additional information was obtained from the Texas Office of the Secretary of State (SOS), which the Department used to identify individuals of Hispanic ethnicity. The Department also obtained credit scores and the related input variables (e.g. number of credit cards, number of collections, etc.) to the credit models from credit vendors. Data regarding race/ethnicity, credit score, credit related variables, policy detail and claim history for each of the 2 million policies was entered into a database for each insurer group and line of business (personal auto or homeowners).

The Department used this data to analyze whether the use of credit scoring: (1) impacts certain classes of individuals more than others; and (2) predicts claims experience. In this regard, it is important to note that unlike previously published studies that relied on aggregate census or ZIP code data to approximate race and ethnicity, the Department's analysis is based on individual data for these characteristics. The Department also reviewed insurer rate filings regarding the use of credit scoring and consumer complaints as part of its analysis.

The Department makes the following initial findings based on a thorough analysis of the collected data, insurer rate filings, and consumer complaints:

- The individual policyholder data shows a consistent pattern of differences in credit scores among the different racial/ethnic groups. The average credit scores for Whites and Asians are better than those for Blacks and Hispanics. In addition, Blacks and Hispanics tend to be over-represented in the worse credit score categories and under-represented in the better credit score categories.

- There appears to be a strong relationship between credit scores and claims experience on an aggregate basis. However, credit scores, to some extent, may be reflective of other risk characteristics associated with claims. It is necessary to evaluate if, and to what extent, credit scoring enables an insurer to more accurately predict losses. Thoroughly analyzing this issue requires simultaneous analysis of the variables affecting likely claims experience. The Department is in the process of conducting a multivariate analysis using the individual policyholder data and will report the results by January 31, 2005.

- The individual policyholder data does not include information on individual income, as this data was not available. The Department performed some limited analysis of the relationship between credit score and median income using Census data by ZIP code. While the differences in average credit scores between income levels are not as large as they are for racial/ethnic groups, the data shows that the average credit scores for upper income level are better than those for lower and moderate income level populations. Additionally, the moderate income level populations tend to be over-represented in the worse than average credit score categories and under-represented in the better than average credit score categories.

- The individual policyholder data shows a consistent pattern of differences in credit scores depending on an individual's age, with younger people having worse credit scores than older people. The best average credit scores are for individuals older than 70.

- The number of credit related consumer complaints submitted to the Department increased substantially from 2000 to 2002 and leveled off at roughly half of their peak since 2002. For the year 2000, the Department received a total of only 40 credit related homeowners and personal auto complaints. By 2002, this number increased nearly 15 times to over 600 complaints. Since 2002, the number of credit related complaints has declined and is currently approximately 300 per year, or five to six per week. It should be noted that complaints related to credit may have also shown other complaint codes related to rating or underwriting.

- Based on a review of rate filings, insurers writing approximately 42% of the homeowners and 55% of the personal auto premiums use credit scoring to some degree in either determining rates or rating tiers. These numbers do not include those insurers whose use of credit information (with consideration of other applicable underwriting factors independent of credit information[1]) is to accept or reject applications for coverage.[2] If this use is included, these percentages increase to 54% and 82%, respectively.

- Based on the Department's review of rate filings, the relative impact of credit scores on rates (from either tiering or rating) varies significantly between insurers. For example, rates varied as little as 11% in one instance to 400% in another due to

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[1] Texas Insurance Code Article 21.49-2U, Section 3, states that an insurer may not deny, cancel, or nonrenew a policy of personal insurance solely on the basis of credit information without consideration of any other applicable underwriting factor independent of credit information.

[2] Underwriting occurs when insurers apply a rule, standard, guideline, or practice, to decide whether to accept or reject an application for coverage or to determine how to classify those risks that are accepted for the purpose of determining a rate, based on individual characteristics. Tiering occurs when insurers apply a rule, standard, guideline, or practice, to decide, for an accepted policy, which particular rating level or tier an insured qualifies for based on individual characteristics. Rating occurs when insurers discount or surcharge a policy based on individual characteristics.

credit score as a measure of risk, with all other rating factors held constant. The variation in rates for any one insurer charging such extremes may have limited impact because there aren't many policyholders at the higher end of the risk/rate spectrum.